

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC: [REDACTED]:TL-N 4515-99  
[REDACTED]

date:

to: [REDACTED], Team Coordinator - [REDACTED]

from: Associate District Counsel, [REDACTED]

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subject: Claim under I.R.C. § 1341  
[REDACTED]

Tax Years: [REDACTED] through [REDACTED]

THIS DOCUMENT MAY CONTAIN TAXPAYER INFORMATION SUBJECT TO SECTION 6103. THIS DOCUMENT MAY ALSO CONTAIN CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND MAY ALSO HAVE BEEN PREPARED IN ANTICIPATION OF LITIGATION. THEREFORE, THIS DOCUMENT SHALL NOT BE DISCLOSED TO TAXPAYERS OR THEIR REPRESENTATIVES OR DISCLOSED OR CIRCULATED BEYOND OFFICE PERSONNEL HAVING THE REQUISITE "NEED TO KNOW."

THE ADVICE RENDERED WILL BE SUBJECT TO 10 DAY POST REVIEW IN THE NATIONAL OFFICE AND MAY BE SUBJECT TO REVISION.

You have requested our advice on the following issue:

ISSUE

Whether the taxpayer may treat environmental clean-up costs paid in the taxable years [REDACTED] through [REDACTED] as items included in gross income under a claim of right in prior taxable years that the taxpayer has restored and to which, therefore, the provisions of I.R.C. § 1341 apply?

CONCLUSION

I.R.C. § 1341 does not apply to allow [REDACTED] to recompute its tax liabilities for the years under audit.

DISCUSSION

[REDACTED] states that it utilized waste disposal practices in prior taxable years which were in accordance with acceptable industry standards. In addition, [REDACTED] indicates that it conducted operations with appropriate business prudence and utilized waste disposal practices that were in conformity with applicable federal and state regulations in effect at the time. Nevertheless, its prior waste disposal practices were admittedly inadequate to prevent the spread of contamination to the surrounding environment at [REDACTED] different manufacturing sites and, as a result, [REDACTED] has incurred additional costs in the current years under audit, ie. [REDACTED] through [REDACTED], to remediate or redispense of its prior manufacturing wastes.

[REDACTED] argues that it included amounts in gross income in prior taxable years through the understatement of its environmental remediation and waste disposal costs incurred in its manufacturing operations. [REDACTED] claims that these expenses are properly characterized as additional costs of goods sold relating to the products manufactured and sold in those prior taxable years. Since costs of goods sold is an element of the computation of gross income for manufacturers under Treas. Reg. §1.61-3(a), the understatement of remediation and other similar-type costs qualifies as an inclusion in prior years' gross income for purposes of I.R.C. § 1341. [REDACTED] argues that it appeared that it had an apparent right to the gross income reported in earlier periods, but its reported income was overstated. According to [REDACTED], I.R.C. § 1341 should apply to the understated waste disposal costs, to mitigate the effect of changes in tax rates between the years that gross income was originally reported and the current years in which deductions for these additional costs are allowed. [REDACTED] maintains that absent the application of I.R.C. § 1341, it will suffer a permanent economic loss, even after allowance of current deductions for these additional expenses.

[REDACTED] has filed an informal claim with the audit team to reduce its tax liabilities based upon the application of the claim-of-right relief provisions of I.R.C. § 1341. The informal claim covers the years [REDACTED] through [REDACTED] and consists of the following amounts:

TAXABLE YEARSAMOUNT

[REDACTED]	\$	[REDACTED]
	\$	
	\$	
	\$	
	\$	

The claim of right doctrine requires that a taxpayer currently include items in gross income when he has received or taken such items under claim of right without substantial restrictions upon disposition. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). In United States v. Lewis, 340 U.S. 590 (1951), the application of the claim of right doctrine resulted in the taxpayer reporting certain amounts in income in 1944 although information discovered in a later year required him under compulsion of a court judgment to refund some of the amounts previously received. The Lewis court held that the subsequent refunding of these items did not permit a recomputation of the tax liability for 1944, the year of inclusion. Rather, the Court held that the taxpayer should deduct the amount of the returned items as a loss in the later year of repayment. Due to a reduction in the effective tax rates from the year of inclusion to the year of deduction, the taxpayer suffered a net tax loss.

To mitigate the sometime harsh result of the Lewis decision, and a tax system based on annual accounting rather than transactional accounting, Congress enacted I.R.C. § 1341, whereunder the tax liability for the taxable year of repayment of an income item is the lesser of the amounts computed under the following two methods:

1. Deduct the repayment in arriving at taxable income, and then compute the resulting tax liability, §1341(a)(4); or
2. Compute the tax for the year of repayment without deduction for the income item, but reduce the resulting tax liability by the reduction in tax that would have occurred in the year of receipt had the amount of the repayment been excluded from income, § 1341(a)(5).

Under I.R.C. § 1341(a), there are three requirements for taxpayers who wish to avail themselves of the above tax relief. First, an item must have been included in gross income for a prior taxable year(s), because it "appeared that the taxpayer had an unrestricted right to such item." I.R.C. § 1341(a)(1). Second, a deduction is allowable for the taxable year, because it was established after the close of such prior taxable year(s) that "the taxpayer did not have an unrestricted right to such item or to a portion of such item." I.R.C. § 1341(a)(2). And third, the amount of such deduction exceeds \$ 3,000. I.R.C. § 1341(a)(3).

Here, [REDACTED] is not entitled to § 1341 relief because its payment of environmental clean-up costs does not constitute the

restoration of an item included in gross income for a prior year under a claim of right. Section 1341 is restricted to items of income previously received and reported by a taxpayer who must repay those same items in a subsequent year. See, Estate of Smith v. Commissioner, 110 T.C. 12 (1998). Understatement of or failure to take a deduction in a prior year, which indirectly results in excessive gross income being reported, provides no basis for application of I.R.C. § 1341. See, Cal-Farms Insurance Co. v. United States, 647 F.Supp. 1083, 1991-92 (ED CA 1986). Remediation costs may be an element of [REDACTED]'s cost of goods sold, and under Treas. Reg. § 1.61-3, "gross income" for a taxpayer which is engaged in manufacturing, such as [REDACTED] means "total sales, less the cost of goods sold." However, it does not follow that unclaimed expenses, even though part of cost of goods sold, represent reported items of gross income within the ambit of I.R.C. § 1341. We believe the correct interpretation of § 1341 and Treas. Reg. § 1.61-3 is that an item of "gross income" means an item of "total sales," which is, of course, clearly includible in the computation of gross income.

Further, I.R.C. § 1341 requires a direct relationship between the item included in gross income and the deductible repaid item. The Tax Court has held that for I.R.C. § 1341 to apply, the deductible restored item must be directly connected to the item that was previously included in gross income. Uhlenbrock v. Commissioner, 67 T.C. 818 (1977). The obligation to repay an item of income must arise out of the specific circumstances, terms and conditions of the same transaction in which the amount was originally required to be included in income. See, Kraft v. United States, 991 F.2d 292, 295 (6<sup>th</sup> Cir. 1993); Pahl v. Commissioner, 67 T.C. 286 (1976); Blanton v. Commissioner, 46 T.C. 527 (1966), aff'd per curiam 379 F.2d 558 (5<sup>th</sup> Cir. 1967). In [REDACTED]'s case, the sale of manufactured goods in prior years and the payment of additional environmental cleanup in latter years are two separate and distinct transactions involving different parties. [REDACTED] incurred its liability for environmental remediation independent from the circumstances, terms and conditions of its sale transactions. In addition, the reported gross income from sales bears no relationship to the amount of cleanup costs that [REDACTED] is now obligated to pay. Thus, the required transactional nexus for § 1341 does not exist.

Even if [REDACTED]'s additional remediation costs could be viewed as items previously included in gross income, I.R.C. § 1341 still does not apply, because the "income" was not included under a claim of right. Treas. Reg. § 1.1341-1(a)(1) provides that "income included under a claim of right" means an item included in gross income, because it appeared from all the facts available

in the year of inclusion that the taxpayer had an unrestricted right to such item. In this case, [REDACTED] reported income from product sales, not because it appeared to have an unrestricted right to such income, but rather because it had an absolute right to such income. Section 1341 does not apply if the taxpayer included income under an absolute right. Rev. Rul. 58-226, 1958-1 C.B. 318.

In prior taxable years, [REDACTED] was under no legal obligation to do more than it did in connection with the treatment and handling of its waste by-products. As indicated above, [REDACTED] claims that it complied with acceptable industry standards in disposing of its waste. Also, it claims that its waste disposal practices were in conformity with applicable federal and state regulations in effect at the time. As of the close of those tax years, [REDACTED] had, as a matter of fact and law, the unrestricted or absolute right to retain the proceeds from its product sales. The fact that subsequent litigation or government regulation created a liability for environmental clean-up does not make § 1341 available to the taxpayer. A later accruing liability does not in any way vitiate [REDACTED]'s right to the sales income at the close of the taxable years in which earned.

[REDACTED]  
Associate District Counsel